

9 September 2016

Superannuation  
Productivity Commission  
Locked Bag 2, Collins Street East  
Melbourne VIC 8003

By online lodgement

Dear Commissioners

**Subject: Submission – Superannuation: draft report on assessment of competitiveness and efficiency**

We are pleased to provide this submission in response to the Productivity Commission's draft report *How to Assess the Competitiveness and Efficiency of the Superannuation System* (the "draft report") released on 2 August 2016.

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We broadly agree with the Commission's high level approach to the assessment of the efficiency and competitiveness of the superannuation system in terms of first defining system-level objectives, then formulating assessment criteria and finally developing performance indicators based on those criteria. However, in reviewing the proposals in the draft report, we have identified a number of concerns and suggestions to assist the Commission in achieving its objectives. The following sections of this submission provide further information. In this submission, page references are to the relevant pages of the draft report.

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In order to assess the competitiveness and efficiency of the superannuation system on a fair and impartial basis, it is essential that the objectives are drafted appropriately. In our view, however, several of the proposed objectives require further consideration.

#### Objective 4.2

Objective 4.2 is currently stated as follows: *The superannuation system maximises net returns on member contributions and balances over the long term* (page 68). This objective would appear to be inconsistent with the terms of reference for the review (page v), which require the Commission to:

*...develop criteria to assess whether and the extent to which the superannuation system is efficient and competitive and delivers the best outcomes for members and retirees, including **optimising risk-adjusted after fee returns**.* [our emphasis]

In our view, in the best interests of members and retirees, the system should optimise – rather than maximise – returns, and those returns should be risk-adjusted, consistent with the terms of reference. We do welcome, however, the focus on net returns, rather than purely on fees and costs without any consideration of the value that is being delivered for members by the fund or investment option.

In terms of the criteria to assess this objective and the indicators to be used, in our view there are a number of complicating factors that must be taken into account. These include the following:

- Defined benefit members in both corporate and public sector defined benefit funds have retirement benefits that are wholly or partially independent of investment returns. Some of these members, particularly but not exclusively in certain public sector funds, may be entitled to defined benefit pensions in retirement. This means that a return-based objective for the superannuation system may be only partially relevant, or indeed wholly irrelevant, for such members.
- Some defined benefit superannuation funds may have investment strategies which are not predicated solely on maximising, or optimising, net returns to members – indeed, as noted above, net returns may not be relevant to defined benefit members' benefits. This is especially the case in unfunded public sector defined benefit funds. However, many defined benefit funds seek to reduce the volatility of returns, and hence their funding status, particularly closed defined benefit funds that are mature. A 'net return to members' objective is not as relevant to these funds. It would be disappointing if such funds were found wanting in the eventual review because this objective was inappropriately applied to them.
- Defined benefit members are not the only members who may complicate a simple, system-wide net return objective. For example, a number of MySuper products have been established with lifecycle investment strategies, whereby cohorts of members are progressively moved to less risky investment strategies as they age. In choice products, where a range of investment options are made available to members, fund trustees aim to optimise net returns within diversified investment options, but this may not necessarily be the goal of options such as single asset options. Finally, optimising net returns within options does not prevent members themselves from making inappropriate investment decisions which lead to sub-optimal retirement outcomes for those members.

#### Objective 4.4

Objective 4.4 is currently stated as follows: *The superannuation system provides insurance that meets members' needs at least cost* (page 69). We note with approval the Commission's acknowledgement that the superannuation system is wider than just the superannuation industry and includes parties such as insurers. On this basis, in our view this objective is too simplistic and does not reflect the breadth of that system.

Meeting members' insurance needs may in fact come at the price of some erosion of members' retirement benefits, due to the deduction of premiums from account balances. In isolation, this objective could be at odds with members achieving adequate retirement benefits. However, in our view this objective should focus on providing access to death and disability benefits in an efficient manner, rather than on cost minimisation. Indeed, we would urge the removal of references to cost, as 'least cost' implies that this is the focus, rather than the provision of cover at a reasonable and sustainable price and with appropriate terms and conditions associated with that cover.

The group insurance market in recent years has been volatile, with insurance premiums incurred by superannuation funds decreasing and increasing rapidly, and with some insurers responding with significant tightening of terms and conditions. It is essential that any insurance-related objective for the superannuation system aims for premiums which are as low as can be achieved on a sustainable basis over the long term.

We also note the Commission's comment (page 69) that *the bundling of group insurance with superannuation is prima facie likely to lead to allocative inefficiency*. In our view this statement, and the subsequent discussion, fails to recognise the efficiencies provided by group insurance at the system level. The provision of group insurance within superannuation:

- Enables individuals to obtain cover more efficiently than if they were to seek it on an individual basis, due to the fact that the majority of members receive cover within their superannuation fund without the need for individual underwriting. This reduces costs for insurers that are in turn passed on to the funds and ultimately the members themselves.
- Generally results in lower premium rates than would be available to members if they were to purchase cover on an individual basis outside superannuation. This is due both to the reduced costs applicable to group cover for the reason discussed above, and also to the ban on acceptance of conflicted remuneration by licensees in relation to group life insurance within superannuation under sections 963E and 963B of the Corporations Act 2001 and by trustees of MySuper products under section 29SAC of the Superannuation Industry (Supervision) Act 1993 (the "SIS Act").
- Enables individuals to obtain cover who may be uninsurable on an individual basis, whether due to health, occupation or other factors. This is partly because the experience of all insured members of the fund is pooled for the purpose of risk rating and pricing by the insurer. This pooling of risk also allows the provision of cover with fewer exclusions than would be available on an individual basis. For example, there remain a significant number of funds – particularly non-public offer funds which are only open to current and past employees of the sponsoring employers and their families – which provide cover without any exclusions for pre-existing conditions.

Group insurance is also subject to conditions imposed by regulation or insurers (or both) which may restrict superannuation funds' ability to offer insurance products that meet members' needs or may restrict or otherwise influence member activities in relation to insurance. It is important that the Commission take these factors into account in both establishing and assessing relevant indicators. These include:

- The ability of members to opt out of insurance cover is frequently restricted by insurers to minimise anti-selection risk which would otherwise lead to increased premium rates. For example, many insurers permit members to opt out of all cover or out of total and permanent disablement (TPD) cover only, but do not permit them to opt out of death cover while retaining their TPD cover. While this might be considered to reflect inefficiency, it ensures premium rates are sustainable over the long term.
- Opt-out of insurance cover is not relevant for defined benefit members where the standard death and TPD benefit is defined by formula specified in the fund's trust deed.

- A number of employers, particularly within corporate funds but also within some master trust sub-plans, seek to ensure that all their eligible employees are provided with insurance cover and therefore meet the premiums associated with such cover with no deduction from members' accounts or erosion of their retirement benefits. Opt-out is also not relevant to these members. Given that some regulator data collection requires insurance premiums (also referred to as "insurance fees" within superannuation) to be reported as charged to the members even if it is not paid for by the members, in our view it is essential that the data used by the Commission for this purpose correctly reflects the source of payment of premiums in these cases.

We note that the terms of reference require the Commission to consider the effect of government policy and regulation on the competitiveness and efficiency of the system. In this context, we would encourage the Commission to consider the different tax treatment that currently applies to death and TPD benefits provided inside and outside superannuation. Amendments to legislation which resulted in a level playing field from a tax perspective, so that superannuation funds, employers and individuals are all treated the same, would improve efficiency and have a number of other benefits. Employers could then elect to provide group death and cover for their employees outside superannuation, on a salary sacrifice basis if appropriate, or with costs met by the employer as an employee benefit. Such cover could be linked to the employee's salary (and hence needs), with terms and conditions negotiated with those needs in mind and not limited by the restrictions imposed by the 'sole purpose test' in section 62 of the SIS Act, and with a more efficient underwriting process (perhaps similar to the automatic acceptance provisions that generally apply to automatic insurance inside superannuation) when moving between employers. This would reduce the need for superannuation funds to provide as much insurance coverage, resulting in less erosion of retirement savings and potentially reducing the number of multiple superannuation accounts as well.

#### **Assessment criteria, indicators and evidence sources**

The following discussion includes both general observations on the assessment criteria, indicators and evidence sources, and some more detailed specific concerns.

- We note that the Commission proposes to collect data in relation to a total of 115 indicators (less a small amount of overlap between those to be used for efficiency and competition). A significant amount of additional evidence, as listed in Table 7.1 of the draft report, is proposed to be collected. It appears that that a material portion of this additional evidence will need to be collected from superannuation funds themselves. We note with approval the Commission's statement (page 159) that *new data or evidence will be sought only where it is feasible to collect within the short to medium term (that is, within the timeframe of the future review) and the benefits of collection are likely to exceed the costs*. We wish to emphasise that the costs of the additional data collection are likely to be passed on to superannuation fund members (as well as distracting trustees from their core business of managing their members' superannuation in the members' best interests) and so we would urge the Commission to make all reasonable efforts to limit the amount of additional data collection required from superannuation funds.
- There are a substantial number of assessment criteria for which the Commission proposes to rely, wholly or partially, on regulator data. These data may be segregated into industry segments using APRA's classification scheme for superannuation funds into retail, industry, corporate and public sector funds, as described on page 30 of the draft report. In this context, it is important to note that in February 2015 APRA revised its segmentation of superannuation funds. Despite its stated objective that the institutions in each segment should be similar to others in their own group and different from institutions in the other segments, APRA's revisions resulted in more than 50% of those funds previously classified as corporate superannuation funds being reclassified as retail. For many of these funds, the only difference between them and other corporate funds was the decision to outsource the trustee function to a professional trustee. We consider that this understates the size of the corporate superannuation fund segment, and we urge the Commission to take this into account if data segmented using this classification system are to be relied on.

- There are indicators, under both the Efficiency and Competition banners, that are not relevant to certain groups of members. Issues in relation to insurance cover, and to indicators in respect of the criteria to assess objective 4.2, have been discussed earlier in this submission. Other such indicators include:
  - Asset allocation data are not relevant to defined benefit members in respect of their defined benefit interests.
  - Data on delayed Superannuation Guarantee (SG) contributions are not collected for defined benefit funds and data on unpaid SG contributions must be used with care, as defined benefit funds on actuarially recommended contribution “holidays” are not receiving employer contributions but nevertheless do not have “unpaid” SG contributions.
  - Certain types of fees are not applicable to defined benefit members in respect of their defined benefit interests. In addition, a number of employers, particularly within corporate funds but also within some master trust sub-plans, pay fund administration and/or advice fees on the members’ behalf as an employee benefit, with no deduction from members’ accounts or erosion of their retirement benefits. Regulator data on fees charged must be used having regard to the source of payment of these fees.
- In relation to measurement of member engagement, a number of superannuation funds either encourage or restrain certain member activities for various reasons, or those activities may be restricted by regulation. Opt-out of insurance cover has been discussed earlier in this submission. Other activities which fall into this category include:
  - Some defined benefit funds do not permit defined benefit members to convert to accumulation benefits and/or transfer out of the fund – for example, in order to minimise anti-selection risk in pension funds. Other defined benefit funds require senior employees of the sponsoring employer who wish to accept promotion beyond a certain level to convert to accumulation benefits.
  - There are a small number of defined benefit funds which provide compulsory non-commutable lifetime pensions to defined benefit members on retirement. Take-up of these products is not necessarily reflective of either the existence or absence of member engagement.
  - Not all defined benefit funds offer their defined benefit members (or any members) choice of investment options in relation to accumulation accounts.
- In relation to whether members and intermediaries are able to make informed decisions, the Commission proposes to measure, among other things, the capacity and willingness of employers to select a default fund. Other indicators which would also indicate this would include the extent of employers meeting various superannuation fund fees (including insurance premiums) in addition to making the minimum SG contributions on behalf of their employees; or the continued willingness to provide defined benefits to employees (where applicable). Indeed, our research suggests that many employers are keen to continue to be involved in the default fund selection process in order to ensure that their employees are provided with an appropriate package of employee benefits including superannuation, and employees both like and trust their employer to take an active role in providing those benefits.

We would be pleased to discuss this letter with the Commission or provide any further information needed. Please do not hesitate to contact us should you wish to do so.

Yours sincerely

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